Nos. 20,391, 20,392 and 20,393

IN THE

United States Court of Appeals

For the Ninth Circuit

FEB 10 1967

DONALD SCOTT, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,391
ROBERT SCOTT, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,392
ESTATE OF BURT EDSALL, Deceased, MARY E. EDSALL, Executrix, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,393

Appeal from the Judgment of the Tax Court of the United States
Honorable Craig S. Atkins, Judge

PETITIONERS' REPLY BRIEF

WILD, CHRISTENSEN, CARTER & BLANK,
By ROBERT G. CARTER,
801 Helm Building, Fresno, California 93721,
Attorneys for Petitioners.

FILED
JUL 1 1966
WM. B. LUCK, CLERK

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Subject Index

Page

Restatement of Petitioners' Contention 1

Respondent's Contention 2

Answer to Respondent's Brief 2

A. Internal Revenue Regulations 3

B. Cases Relied Upon by Respondent 7

Argument 12

Conclusion 14

Certificate of Attorney Preparing Brief 15

Table of Authorities Cited

Cases Pages

Blethen v. Pacific Mutual Life Insurance Company, 198 Cal. 91, 243 Pac. 431 ....5, 8, 11

Commissioner v. Chase Manhattan Bank, 259 Fed. 2d 231.. 10

Estate of Castagnola, 68 Cal. App. 732.................... 10

Estate of Dobbel, 104 Cal. 432, 38 Pac. 87................ 5, 8

Estate of Mazie O. Mendenhall, 182 Cal. App. 2d 441, 6 Cal. Rptr. 45 8

Estate of Parr, 24 Cal. App. 2d 171, 74 Pac. 2d 792....... 11

Estate of Wedemeyer, 109 Cal. App. 2d 67, 240 Pac. 2d 8 10

Fidelity and Casualty Company v. Mahoney, 71 Cal. App. 2d 65, 161 Pac. 2d 944.................................. 11

Kanigo v. Grover, 208 Cal. App. 2d 134, 24 Cal. Rptr. 158 12

Mazman v. Brown, 12 Cal. App. 2d 272, 55 Pac. 2d 539.... 11

Pages

Morghee v. Rouse, 224 Cal. App. 2d 745, 37 Cal. Rptr. 112 12

Mundt v. Connecticut General Life Insurance Company, 35 Cal. App. 2d 416, 95 Pac. 2d 966 11

New York Life Insurance v. Bank of Italy, 60 Cal. App. 602, 214 Pac. 61 5, 9, 11

Polk v. Polk, 228 Cal. App. 2d 763, 39 Cal. Rptr. 824 11

Travelers Insurance Company v. Fancher, 219 Cal. 351, 26 Pac. 2d 482 5, 11

United States v. Stewart, 270 Fed. 2d 894 7, 11

Codes

California Civil Code:
- Section 161(a) 13
- Section 172 10, 11
- Section 172(a) 11

California Probate Code:
- Section 201 13
- Section 202 11, 12

Regulations

Treasury Regulations on Estate Tax (1954 Code), Section 20.2042-1(c)(5) 6

Nos. 20,391, 20,392 and 20,393

IN THE

United States Court of Appeals

For the Ninth Circuit

DONALD SCOTT, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,391
ROBERT SCOTT, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,392
ESTATE OF BURT EDSALL, Deceased, MARY E. EDSALL, Executrix, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,393

Appeal from the Judgment of the Tax Court of the United States
Honorable Craig S. Atkins, Judge

PETITIONERS' REPLY BRIEF

RESTATEMENT OF PETITIONERS' CONTENTION

It is the contention of Petitioners that only one-half (½) of the proceeds of the insurance policies on the decedent's life are includable within his gross estate for estate tax purposes. The law of the State

of California determines the character, nature and quality of property bequeathed or devised. Under California community property law insurance policies and the proceeds thereof, purchased with community funds, are community property, and as such are subject to the same rules as other community property over which the predeceased wife has an absolute power of testamentary disposition. One-half (½) of the interest in said policies having been disposed of by the predeceased wife, the husband had left to bequeath only a one-half (½) interest therein.

RESPONDENT'S CONTENTION

It is Respondent's position that the predeceased wife's interest in community property insurance policies on the life of her husband is limited to the amount of the cash surrender value of said policies at the time of her death; that the predeceased wife has no power of testamentary disposition over the insurance policies as such; and that under the laws of the State of California and the Regulations of the Internal Revenue Service the entire amount of the proceeds of said policies must be included in the husband's gross estate, less an amount equal to one-half (½) of the cash surrender value of said policies as they existed at the death of the predeceased wife.

ANSWER TO RESPONDENT'S BRIEF

Respondent fails to appreciate the nature of California community property and its application to in-

surance policies. Respondent has neglected to consider the appropriate Internal Revenue Regulations and to properly interpret the California statutory and case law as it applies to the wife's interest in community property insurance policies.

A. INTERNAL REVENUE REGULATIONS

Respondent has taken the position that Dr. Scott retained, after the death of his wife, all of the incidents of ownership with respect to the named insurance policies (BR 11-13); and, therefore, irrespective of California community property law, the entire amount of the proceeds of said insurance policies are includable within the gross estate of the decedent, Dr. Scott. As authority for Respondent's position, Respondent has cited Treasury Regulation on Estate Tax (1954 Code) Section 20.2042-1(c)(2 and 5). Said regulation provides that the proceeds of insurance policies on the life of the decedent shall be includable within the estate of decedent *if* the decedent possessed at his death incidents of ownership over the same.

The Respondent contends that the decedent had the power to assign and revoke assignments of the policies, the right to change the beneficiaries, pledge the policies for a loan, or obtain loans against the surrender value of the policies, and surrender the policies, limited only by the right of legatees under his wife's Will to claim their community interest at the time of her death. It is true that subsequent to Mrs. Scott's death the sons were named beneficiaries under the

policies and that a loan was obtained against their surrender value by Dr. Scott. These factors, however, do not determine or establish that Dr. Scott in fact possessed incidents of ownership over the whole of the policies. What the principals of a contract may believe with respect to their legal rights does not create, establish or determine said legal rights. Furthermore, although the conduct of the parties to a contract may at times demonstrate their intention or belief, they cannot unilaterally deprive another party to the contract of his or her legal rights. The action taken by Dr. Scott with the acquiescence of the insurer, merely indicates a mutual lack of awareness of the nature of the interest which passed to the sons by virtue of Mrs. Scott's Will.

Respondent states that the insurance policy is only a document setting forth the terms and conditions of the contract of insurance between the insured and the insurer and a contract to which the wife is not a party. (BR 13.) To the contrary, however, the California wife is a party in interest to any contract entered into by her husband by virtue of her vested interest in the community property. The mere fact that she is not a named party to the contract is not decisive. She is deemed a party in interest by virtue of her community property rights. The wife's ownership interest in community assets cannot be divested by her husband by his mere refusal to include her as a named party to the contract. It would be a harsh rule and completely contrary to the law of this state to declare that the wife's ownership interest in com-

munity property depends upon whether or not she was named in the contract entered into by her husband. Under such a rule, a husband could adversely affect the wife's property rights through the simple process of transforming community funds into paid up insurance policies, executory contracts or other choses in action. By virtue of the California husband's right to the management and control of the community property, the wife could not set aside during her lifetime such a purchase and under the position contended for by Respondent, at the wife's death she would have nothing more than an interest in the cash surrender or other contingent value of the insurance policy, executory contract or chose in action.

It is inconceivable that Respondent should ask this Court to adopt an unsound principle of law, the effect of which would mean that the California wife has no interest as an owner at death in an asset which was purchased with community funds and which, in the absence of death the wife retained a present, existing and equal interest with that of her husband. Such a rule would defy reason and logic.

Respondent's contention that the interest of the wife in an insurance policy on the life of her husband is not that of an *owner* of the policy (BR 7) is not in accord with California law. *Blethen v. Pacific Mutual Life Insurance Company,* 198 Cal. 91, 98, 243 Pac. 431; *Estate of Dobbel,* 104 Cal. 432, 38 Pac. 87; *Travelers Insurance Company v. Fancher,* 219 Cal. 351, 26 Pac. 2d 482; *New York Life Insurance v. Bank of Italy,* 60 Cal. App. 602, 214 Pac. 61.

By virtue of Mrs. Scott's death, Dr. Scott clearly lost any incidents of ownership which he might have had over her one-half (½) interest in said policies. This position is sound and is recognized and supported by Treasury Regulations on Estate Tax (1954 Code) Section 20.2042-1 (c) (5), the latter portion of which was conspicuously omitted in Respondent's Brief.

The latter portion of the above mentioned subsection provides:

> ". . . For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary, but retaining the right to surrender the policy. Under the law the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered and that the son receives the proceeds on the decedent's death, the wife's transfer of her one-half interest in the policy was not considered absolute before the decedent's death. Upon the wife's prior death, one-half of the value of the policy would have been included in her gross estate. *Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy, is not for the purposes of this section an 'incident of ownership', and the decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.*" (Emphasis added.)

In the present case the insurance policies having been purchased with community funds constituted community property. The decedent husband possessed

incidents of ownership with respect to one-half (½) of the policies only and, consequently, only one-half (½) of the proceeds of said policies are properly includable within his gross estate.

B. CASES RELIED UPON BY RESPONDENT

(1) Respondent relies substantially upon *United States v. Stewart,* 270 Fed. 2d 894, which has been cited throughout its Brief. (BR 4, 10, 16, 22, 23 and 24.) The Court in the *Stewart* case at page 902, stated specifically that

> ". . . we can find no warrant in California law for treating life insurance as a community asset differently from other kinds of property, we hold that at the time of the wife's death she had a present, existing and equal interest with her husband in the policies; . . ."

It is true that the Court went on to state that the interest of the wife amounted to ownership of one-half of whatever the value of the policies were at the time of her death and further that such amount must be included within her gross estate. However, as is fully apparent the Court in the *Stewart* case was concerned only with the *amount* which should be includable in the wife's gross estate and was not confronted with the question of the precise nature and extent of her interest and whether or not the same could be bequeathed by her. To glean from the Court's decision that the wife had only an interest in the cash surren-

der value of the policies is contrary to the Court's recognition that the wife had a present, existing and equal interest with that of her husband in the policies. In light of its actual holding, the *Stewart* case is fully in accord with the California community property law and the California cases concerned with community property insurance policies.

(2) The Respondent has sought to distinguish the cases of *Estate of Dobbel,* 104 Cal. 432, 38 Pac. 87, and *Estate of Mazie O. Mendenhall,* 182 Cal. App. 2d 441, 6 Cal. Rptr. 45, by pointing out that in each case the Court was concerned with a *paid-up* policy. The distinction has no bearing whatsoever on the question of rights. The fact that the policy is paid up merely means that the condition of continued payment of premiums as a prerequisite to enforceability has been removed. Whether the premiums are paid in advance or over a period of time is of no consequence insofar as determining the extent of the wife's community property interest. The only consideration of importance is, not how the premiums are paid, but the character of the funds which are used for this purpose.

(3) Respondent has also attempted without success to distinguish the case of *Blethen v. Pacific Mutual Life Insurance Co.,* 198 Cal. 91, 243 Pac. 431, on the technical ground that the question involved there was whether a surviving wife may maintain an action against an insurance company to recover her community interest in the proceeds of a life insurance policy issued to her husband and made payable to a beneficiary other than the wife, without the wife's

consent. The wife was denied recovery for the reason that no notice of any adverse claim to the proceeds of the insurance policy was given prior to the good faith payment of the proceeds to the beneficiary. The Court stated, however, at page 99, that

> "the *proceeds* of an insurance policy, the premiums on which have been paid out of community assets, are community property." (Emphasis added.)

The clear import of such statement cannot be lightly cast aside.

(4) Respondent argues that since Mrs. Scott predeceased her husband her community property interest in the subject insurance policies could extend to cover only policy rights and not proceeds rights (BR 20-24), and as authority therefor cites language in *New York Life Insurance Co. v. Bank of Italy,* 60 Cal. App. 602, 607, 214 Pac. 61, page 63, to the effect that the interest of the wife *eo instante* ripens and is payable at the instant of the husband's death. Respondent has failed again to distinguish between the interest of an owner of an insurance policy prior to the fact of death of the insured and the right to the proceeds when the fact of death has occurred. There is no suggestion in the *Bank of Italy* case that the proceeds of an insurance policy must become due and payable before a community interest can extend to the proceeds themselves. At page 607 the Court pointed out that

> "what we have said disposes of the contention that in order to be classed as community property the proceeds of the insurance must actually have

> become property of the spouses during their joint lives."

Subsequent California cases have examined and reaffirmed this principle. *Estate of Castagnola,* 68 Cal. App. 732, and *Estate of Wedemeyer,* 109 Cal. App. 2d 67, 240 Pac. 2d 8. In the *Castagnola* case the Court stated at page 737

> "the policy of insurance being a chose in action which was community property of the parties during their coverture, the *proceeds* of the policy would retain their community character, notwithstanding the fact that they were paid after the dissolution of the community." (Emphasis added.)

(5) Respondent's overall confusion may be partly attributable to the failure to distinguish the case of *Commissioner v. Chase Manhattan Bank,* 259 Fed. 2d 231. (BR 20.) The community property laws of the State of Texas and of the State of California differ considerably. In Texas the rule is that the insurance policy is community property as to policy rights, but that the transfer or conversion of those rights into proceeds rights by a contract entered into by the husband, in the absence of fraud, cuts off the wife's community property interest. *Commissioner v. Chase Manhattan Bank* (supra). In California, however, the result is entirely different. Under California Civil Code Section 172, any gift of community property without the wife's written consent may be set aside as voidable. During the husband's lifetime, the gift may be set aside entirely; after the husband's death, insurance, for example, is voidable to the extent of

one-half ($\frac{1}{2}$) of the policy proceeds. *New York Life Insurance Company v. Bank of Italy,* 60 Cal. App. 602, 214 Pac. 61. This principle is recognized in *United States v. Stewart,* 270 Fed. 2d 894, 900 and is well established. *Travelers Insurance Company v. Fancher,* 219 Cal. 351, 26 Pac. 2d 482; *Blethen v. Pacific Mutual Life Insurance Company,* 198 Cal. 91, 243 Pac. 431; *New York Life Insurance Company v. Bank of Italy,* 60 Cal. App. 602, 214 Pac. 61; *Polk v. Polk,* 228 Cal. App. 2d 763, 39 Cal. Rptr. 824; *Mazman v. Brown,* 12 Cal. App. 2d 272, 55 Pac. 2d 539; *Estate of Parr,* 24 Cal. App. 2d 171, 74 Pac. 2d 792; *Mundt v. Connecticut General Life Insurance Company,* 35 Cal. App. 2d 416, 95 Pac. 2d 966; *Fidelity and Casualty Company v. Mahoney,* 71 Cal. App. 2d 65, 161 Pac. 2d 944.

(6) Respondent takes the further position that California Probate Code Section 202 supports its position of the husband's absolute ownership in the insurance policies of the wife. Such argument is wholly erroneous. The respective interests of the husband and wife in community property during the continuance of the marriage relation are present, existing and equal interests under the management and control of the husband. California Civil Code Sections 172 and 172(a). California Probate Code Section 202 merely insures that the husband's power of management and control over the community property will continue after death pending the administration of her estate, except to the extent necessary to carry her Will into effect. This power of management and con-

trol which the surviving husband retains extends only during the period of administration of the deceased wife's estate. The scope and purpose of Section 202 of the California Probate Code are summarized in *Kanigo v. Grover,* 208 Cal. App. 2d 134, 24 Cal. Rptr. 158, page 146,

> "however, the subject section does not purport to give the husband the right to consume his wife's share of the community property, which was subject to her testamentary disposition, by giving it away or by using it in the payment of debts incurred by him after her death which had no relationship or preservation of their property. The obvious purpose of this statute is to permit the husband to retain possession of the community property except insofar as it is necessary to carry his wife's Will into effect. Consistent with this purpose, he may be required to account to her personal representative for her share."

The Court concludes at page 146,

> "his status in the premises is analogous to that of a trustee authorized to manage and deal with trust property".

See also *Morghee v. Rouse,* 224 Cal. App. 2d 745, 37 Cal. Rptr. 112.

ARGUMENT

Respondent has repeatedly failed to grasp the distinction between the value of an asset and the asset itself. Respondent's Brief incorrectly states that it is Petitioners' contention that by Mrs. Scott's Will she made a testamentary disposition of one-half (½)

of the proceeds payable under the policy on the life of her husband upon his subsequent death. On the contrary, Petitioners contend that Mrs. Scott made a testamentary disposition of her one-half (½) of the community assets—the life insurance policies themselves—and that this interest included all of the rights, powers and privileges incidental thereto. The Petitioners herein, sons of Mrs. Scott, succeeded to exactly the same interest in the insurance policies which their mother had at the time of her death. Any conclusion to the contrary flies in the face of the clear language of California Civil Code Section 161(a) and California Probate Code Section 201.

Respondent throughout its brief has contended that Petitioners ignore the difference between "policy rights and proceed rights". It is without argument that at the time of the demise of Mrs. Scott the decedent was still living and consequently Mrs. Scott had no unconditional right to the insurance proceeds. The conditions precedent to the duty of the insurer to pay said proceeds had not yet occurred. By the same token Dr. Scott would never have the right of enjoyment as a result of the nature of an insurance contract. He, too, had only the right to benefit a third party upon his death, provided the premiums were paid up to that moment in time. There is no distinction between policy rights and proceed rights.

If the right of testamentary disposition depended upon the right of enjoyment of the insurance proceeds, then the same rule by analogy should apply to an insurance policy paid for with the wife's separate property.

Following Respondent's argument if Mrs. Scott had taken out a life insurance policy on the life of her husband and paid the premiums thereon from her separate property, then upon predeceasing her husband, she could bequeath only the cash surrender value of said policy—a rather substantial windfall to the insurance companies. By the same token, under the theory advanced by Respondent, if Mrs. Scott had owned a community interest in an unmatured promissory note at her death, all she could pass on to her sons would be its discount value, since the duty to pay the full amount of principal and interest would not yet have matured. Mrs. Scott's interest in the insurance policies, whether community or separate, was a valuable right which she could pass on to her sons by Will and who by continuing the policies in force would claim the proceeds and realize the enjoyment thereof upon the death of Dr. Scott.

Respondent's argument of policy rights vs. proceed rights is a distinction without a difference under California law.

CONCLUSION

Mrs. Scott at the time of her death possessed, under California community property law, a present, existing and equal interest to that of her husband in the subject insurance policies and her sons received said interest by virtue of her bequest. Her sons received a one-half (½) interest in said insurance policies and not merely a one-half (½) interest in the cash surrender value thereof. To hold otherwise would be

grossly unfair and contrary to the community property laws of the State of California. Petitioners submit that the decision of the Tax Court should be reversed.

WILD, CHRISTENSEN, CARTER & BLANK,
By ROBERT G. CARTER,
Attorneys for Petitioners.

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing is in full compliance with those rules.

ROBERT G. CARTER
Attorney

I certify that a copy of the above and foregoing Brief was this date deposited in the United States Mail, postage prepaid, in a cover addressed to Melvin L. Sears, Regional Counsel, U. S. Treasury Department, Internal Revenue Service, Room 628, 447 Sutter Street, San Francisco, California.

Dated, Fresno, California,
June 28, 1966.

ROBERT G. CARTER
Attorney